



United States General Accounting Office

Testimony

Before the Committee on Small Business
U.S. Senate

For Release on Delivery
Expected at
10:00 a.m. EDT
on Tuesday
May 23, 2000

TAX ADMINISTRATION

IRS' Efforts to Serve Small Business Taxpayers

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Tax Administration: IRS' Efforts to Serve Small Business Taxpayers

Mr. Chairman and Members of the Committee:

We are pleased to be here today to discuss the factors that complicate small businesses' efforts to comply with the tax laws and the Internal Revenue Service's (IRS) efforts to provide better service to this important group of taxpayers. According to IRS, there are about 40 million small businesses and self-employed taxpayers in the United States who are responsible for remitting nearly half of the taxes collected by IRS.

Congress, in the IRS Restructuring and Reform Act of 1998, mandated that IRS place more emphasis on providing better service to taxpayers. In response, IRS has undertaken a long-term effort to modernize itself, including reorganizing into four operating divisions, each of which is to focus on a particular group of taxpayers. One division, the Small Business and Self-Employed Operating Division (SB/SE) is to serve small corporations and partnerships, farmers, and other self-employed individuals—a group that we will call “small businesses”. One of SB/SE's major challenges will be to help relieve the compliance burden, including the time and other costs of complying, that federal tax rules place on small businesses.

Our remarks today are based on the results of two studies the Committee asked us to do—one on the extent to which IRS' plans for SB/SE address factors that have complicated past interactions between small businesses and IRS and another on IRS' new taxpayer burden estimation models. The first study is ongoing, and our remarks today are based on preliminary results. We have completed the second study, and our report is being released today.¹

In summary, several factors have complicated the interactions between small businesses and IRS. First, small businesses are more likely than other taxpayers to have compliance problems, which is not surprising given the complex tax issues and requirements that a small business can face and the fact that small businesses do not always have the kind of resources needed to understand and deal with those issues and requirements. Second, IRS' organizational structure and its focus on correction rather than prevention have hampered its ability to meet the needs of small businesses. Third, small businesses are often reluctant to seek help from IRS, which could be due in part to past negative experiences.

¹ Tax Administration: IRS Is Working to Improve Its Estimates of Compliance Burden (GAO/GGD-00-11, May 22, 2000).

Although IRS' plans for SB/SE address these complicating factors, such things as the diversity of the small business population, IRS' antiquated computer systems, a shortage of staff with needed skills, and the need for an integrated performance management system will challenge IRS as it implements those plans.

One aspect of performance management involves development of an appropriate set of performance measures, and one important measure is compliance burden. IRS is pursuing a multi-phased approach in developing new methods for estimating that burden. With the help of a contractor, IRS is developing models that, when compared with IRS' current methodology, are designed to produce more comprehensive estimates of federal income tax compliance burdens and to provide IRS with a greater capacity to analyze the impact of tax law and administrative changes on those burdens. However, as with all models, the specific capabilities and precision of the new models will depend on the quality of the underlying data.

Various Factors Complicate the Interactions Between Small Businesses and IRS

From responses to our survey of small businesses² and the results of interviews with IRS officials and representatives of the small business community, we identified several factors that complicate the interactions between small businesses and IRS. Those factors relate to (1) the potential for noncompliance among small businesses, (2) the way IRS has structured its organization and allocated its resources, and (3) the reluctance of small businesses to go to IRS for help.

Small Businesses Have a Greater Potential for Noncompliance

According to IRS, small businesses are more likely than other taxpayers to have compliance problems. IRS data show, for example, that small businesses tend to have more collection cases involving withheld employment taxes than do larger businesses.

Complexity was the most commonly mentioned reason why small businesses might have trouble complying. Small businesses, like larger businesses, can encounter such complex tax issues as employment taxes and depreciation and are subject to multiple layers of filing, reporting, and

² We sent a survey to a stratified random sample of 1,000 small businesses representing a study population of 398,105 small businesses nationwide. We identified the study population from the membership list of the National Federation of Independent Businesses (NFIB). After considering a number of national organizations that represent small businesses, we chose NFIB because its membership was the largest and included members from a wide range of business sectors. We reached a general consensus regarding this choice with cognizant officials from IRS, the Small Business Administration, and a number of other membership organizations that represent small businesses. Fifty-five percent of the small businesses responded to our survey. The results of our survey can only be generalized to the population of NFIB members.

deposit requirements. However, small businesses do not always have the kind of resources on a continual basis that they need to understand and deal with those issues and requirements.

Other factors mentioned as contributing to a small business' potential for noncompliance were (1) the fact that business income, unlike wages and investment income, is generally not subject to withholding or some form of information reporting and (2) cash flow limitations. It is generally recognized that compliance is highest when taxes have been withheld (as is the case with wages) or when a third party (such as a bank or mutual fund) reports payments (such as interest and dividends) to IRS. Cash flow limitations can cause a small business to become delinquent in making required tax payments or in remitting taxes that have been withheld from employees.

IRS Has Not Operated in a Way That Best Enables It to Serve Small Businesses

IRS' ability to meet the needs of small businesses has been hampered in the past by its organizational structure and its focus on problem correction versus prevention.

Under IRS' current organizational structure, authority for serving taxpayers and administering the tax code is decentralized to 33 districts and 10 service centers, each of which is organized along functional lines, such as collection, examination, and taxpayer service. Because IRS allocates its resources, such as staff and information systems, along geographic and functional lines, it is designed to handle a wide range of issues pertaining to all taxpayers—from individuals whose sole income is from wages to multi-national corporations—with little or no focus on specific taxpayer segments, such as small businesses. For example, IRS has dozens of discrete databases that are function specific and are designed to reflect transactions at different points in the life of a return or information report—from receipt to disposition. As a consequence, IRS does not have any easy means to access comprehensive information about small business taxpayer accounts, which can inhibit its ability to identify and resolve tax compliance problems of small businesses.

IRS has also historically allocated most of its resources to correcting problems after they occur rather than preventing problems from occurring. According to IRS, it allocates about 11 percent of its budget for customer education and assistance (i.e., problem prevention) compared to 72 percent for compliance (i.e., problem correction). The other 17 percent is allocated to customer account services. This emphasis on correction versus prevention can be especially problematic for small businesses that need assistance up front and that, absent that help, are at a high risk

of going out of business if problems arise. In other words, by the time IRS determines that a small business has a compliance problem and sets out to correct the problem, it may be too late.

Small Businesses Are Often Reluctant to Go to IRS for Help

Small business representatives told us that small businesses are often reluctant to go to IRS for help. In that regard, our survey results showed that many small businesses (1) were either unaware of key IRS services or knew of the services but did not use them and (2) expressed negative feelings about their past interactions with IRS.

Many Small Businesses Were Unaware of Key IRS Services, and Many Who Knew of the Services Did Not Use Them

IRS has certain services, such as outreach seminars and a small business corner on its World Wide Web site on the Internet, that it has developed specifically for small businesses. However, our survey indicated that many small businesses are unaware of those services and many others who know of the services do not use them.

For example, of the 398,105 small businesses in our survey population, an estimated 52 percent were not aware of IRS' outreach seminars, and an estimated 38 percent were aware of the seminars but had not used that service. Likewise, an estimated 58 percent of our survey population were not aware of the small business corner on IRS' Internet site, while another 31 percent were aware of that service but had not used it.

Small business owners participating in IRS focus groups indicated that they had limited familiarity with or use for IRS' products and services because they relied on tax practitioners.³ Small business representatives told us that small businesses would rather rely on tax practitioners because they are too busy, they do not trust IRS, or IRS' services are not conveniently offered. For example, one small business owner responding to our survey commented that certain IRS services, such as walk-in sites and outreach seminars, are not available in small towns and that it would be helpful if there was more information available on IRS' Internet site. Another small business owner commented that he would personally find it difficult to contact any source other than a local tax preparer for information because of fear of an audit. He further suggested that IRS needs to change the image that it treats small businesses as tax cheats.

³ According to IRS, between 80 and 88 percent of small businesses rely on tax practitioners to prepare their returns.

Small Businesses Had Mixed Feelings About Their Past Interactions With IRS

Small businesses can have a variety of interactions with IRS ranging from general written advice, such as that provided through tax publications, to more personalized service, such as that provided over the telephone or at walk-in sites, to enforcement actions, such as audits. Negative reactions of small businesses to any such interactions in the past can complicate their future relationships with IRS.

Our survey included several questions about small businesses' interactions with IRS over the past 5 years, including their level of satisfaction or dissatisfaction with several aspects of IRS' service. More small businesses in our study population were satisfied with the overall quality of IRS' service than were dissatisfied. However, when asked about selected interactions with IRS, small businesses had mixed feelings. For example, when asked about the availability of forms and publications or IRS' timeliness in issuing refunds, many more businesses commented positively than negatively. The opposite was true, however, when they were asked about such things as the understandability of forms, publications, and notices; the accessibility of IRS' telephone assistance; and the levying of penalties.

Several respondents who expressed dissatisfaction with certain aspects of IRS' service provided narrative comments to explain their feelings. For example, one respondent commented that IRS' instructions have too much fine print and not enough plain English. Two additional examples follow:

"when I do finally get a phone call through, I [dislike] all of the menus that you go through and the passing from one person to another when you finally do get to talk with a human. I also despise the noncaring, uninterested attitude that I usually get from IRS employees."

"The frustrating thing about [IRS] is they send you a notice about tax discrepancies, you answer and about a month later you get another notice. You answer again and then you get a notice telling you this is your final notice. They need to have a person assigned to your tax problem so you could call them and work it out. It seems most of the time the person sending you the notice never sees your replies."

Some small business owners and representatives said that, although IRS can improve its services, dissatisfaction with IRS is often misplaced. For example, one small business representative said that many small businesses that are dissatisfied with IRS have likely had little experience with IRS and are really expressing their dissatisfaction with the complex tax code.

Reorganization May Enable IRS to Address Factors That Have Complicated Its Interaction With Small Businesses, But Implementation Will Not Be Easy

IRS is implementing a major reorganization that is to, among other things, structure the agency around four primary customer segments and operating divisions. One of those operating divisions—SB/SE—is to focus on taxpayer education and assistance, specialized account services, and revamped compliance efforts tailored to small businesses.

The various changes discussed in IRS' plans for the new organization indicate that it will be taking steps to address those factors that have been identified as complicating the interaction between IRS and small businesses. Although the new organization may not be able to do much to reduce the complexity facing small businesses, it should be able to help businesses better deal with those complexities and increase taxpayer satisfaction. By dedicating an operating division to small businesses, increasing its knowledge base on the characteristics and needs of the population, and customizing its products and services to meet those needs, IRS intends to shed the limitations of its historic structure and improve its customer focus.

Under the new organization, IRS also intends to shift the allocation of its resources to help small businesses meet their tax requirements. For example, IRS currently allocates few resources toward problem prevention activities, such as taxpayer education and assistance, compared to problem correction (e.g., enforcement) activities. IRS recognizes the need for a greater focus on education and assistance and intends to increase the number of staff dedicated to small business education and communication from fewer than 100 in its current organization to about 1,300 in SB/SE.

Although IRS intends to increase its taxpayer education efforts, it recognizes that many small businesses are reluctant to go to IRS for help. To increase the effectiveness of its efforts, IRS intends to provide needed information by partnering with tax practitioners and other outside organizations from which small businesses are less reluctant to seek help and by focusing attention on those small businesses most in need of help, such as start-up businesses.

IRS also intends to improve overall compliance among small businesses through a revamped compliance strategy that integrates its traditional enforcement activities (exam and collection), while blending in a mixture of education and outreach services, using a risk-based approach. For example, IRS' current collection process is a "one-size fits all" approach that treats all taxpayers alike. Under its new approach, IRS intends to segment small businesses with collection issues by risk. A low risk small business would most likely receive a blend of education and enforcement

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activities, while a high-risk small business might receive aggressive enforcement action. The goal of this approach is to intervene as early and quickly as possible to address small business compliance issues. Specific details about this new approach, such as the criteria that will be used in assessing risk, have yet to be developed.

All of this assumes that the various changes discussed in IRS' plans come to fruition. However, implementing the new operating division will not be easy. Some of IRS' plans, such as those related to partnering, might not take long to implement. Others, such as those related to risk-based enforcement, could take much longer.

Besides time, there are several other challenges that the new operating division and IRS must confront. For example, the size and diversity of the taxpayer population for which the new operating division will be responsible could stretch the capabilities of management and staff and dilute the division's customer focus. The new division also will be (1) hindered in its ability to deliver new programs and services by antiquated information systems and a shortage of staff with needed skills and (2) challenged, as is all of IRS, to develop an integrated performance management system that creates incentives for employee behavior that supports organizational goals.

**Challenges to SB/SE's
Taxpayer Focus**

Although creation of SB/SE should facilitate a sharper focus on the needs and problems of small businesses than is possible under the current organization, the division will be challenged by the need to (1) serve a large and diverse population and (2) devise effective procedures for dealing with taxpayers who migrate between operating divisions.

According to IRS, the approximately 40 million taxpayers to be served by SB/SE include about 6.2 million small partnerships and corporations; 19.3 million partially or fully self-employed individuals;⁴ 13 million individual filers with supplemental income or business expenses;⁵ and 1.2 million non-small business taxpayers who are considered specialty tax filers.⁶ Compared to SB/SE, (1) the Wage and Investment Income Operating

⁴ According to IRS, as many as one-half of self-employed filers receive the vast majority of their income from wages, not business-related enterprises, and should be considered "incidental" business filers. Nevertheless, these filers are included in IRS' definition of small business and in the population to be served by SB/SE.

⁵ Supplemental income earners are wage earners who file a Form 1040 with a Schedule E for rental, royalty, or other supplemental income. Wage earners with business expenses file a Form 1040 with a Form 2106 attached.

⁶ Specialty tax filers include international filers and filers of fiduciary, excise, and estate tax returns.

Division is to serve a larger but less diverse customer segment (about 116 million taxpayers who only have wage and investment income) and (2) the Large and Mid-size Business Operating Division is to serve a smaller and less diverse population (about 210,000 corporations and partnerships with assets of more than \$5 million).

The diversity of the small business population will require that SB/SE staff specialize in a wide range of tax issues and deal with a wide range of taxpayer needs. For example, the needs of wage earners who also operate small, one-person businesses from their homes can vary significantly from corporations that employ 100 persons and have gross receipts in excess of \$1 million.

Besides handling the workload for its own diverse population, SB/SE is also expected to work for other operating divisions. For example, SB/SE is to conduct certain audit and collection activities for the Wage and Investment Income Operating Division. These additional responsibilities could stretch the capabilities of management and staff in SB/SE and dilute its taxpayer focus.

Taxpayer migration also poses a challenge to the taxpayer focus intended by the reorganization. Migration refers to scenarios under which a taxpayer might qualify as a small business one year but not the next, or vice versa. These scenarios could cause taxpayers to change operating divisions from year to year under the new organization. For example, according to IRS data, about 2.2 million individuals who had filed for tax year 1995 as pure wage earners (i.e., the kind of taxpayer for which the Wage and Investment Income Division is to be responsible) filed for tax year 1996 as sole proprietors (i.e., SB/SE-type taxpayers) and 1.7 million individuals who had filed as sole proprietors for tax year 1995 filed as pure wage earners for tax year 1996. Similarly, a corporation or partnership could have more than \$5 million in assets one year (and thus be part of the population to be served by the Large and Mid-size Business Operating Division) and \$5 million or less in assets the following year (which would make it part of SB/SE).

IRS acknowledges that taxpayer migration could present account management problems for SB/SE and other operating divisions. Specifically, this issue could lead to disparate treatment of taxpayers and hamper IRS' ability to provide end-to-end accountability because the responsibility for managing a migrating taxpayer's account could shift from one operating division to another. IRS is working on plans to put processes in place to allow for greater interaction between the account

management units within the operating divisions to properly manage and serve migrating taxpayers.

Challenges to SB/SE's Ability to Deliver New Programs and Services

SB/SE will also be challenged to deliver the various new programs and services discussed earlier. In general, the division's challenges derive from (1) antiquated computer systems and (2) a shortage of staff with needed skills.

IRS' antiquated computer systems have long hindered agency efforts to manage operations and better serve taxpayers. IRS has struggled with systems modernization for years, and we have made numerous recommendations to correct management and technical weaknesses that jeopardized the modernization process.⁷ Although IRS has made progress in addressing our recommendations, it has yet to fully implement them. More specifically, IRS needs to fully implement key controls that are needed to effectively guide and constrain modernization initiatives. These controls include (1) completing a blueprint for modernization; (2) implementing a "systems life cycle" process, including development of business cases, to manage system investments; and (3) establishing a fully operational management structure to oversee systems modernization. Without systems improvements, IRS managers will continue to have a difficult time monitoring and managing program outcomes—including identifying taxpayer needs and evaluating the effectiveness of programs to meet those needs.

Improvements to IRS' information systems are critical to SB/SE's overall success. IRS acknowledges, for example, that small business taxpayer education and communication initiatives depend on substantial investments in computer hardware and software and that major systems changes will be required to support a risk-based compliance strategy.

A shortage of staff with needed skills can also adversely affect SB/SE's ability to deliver new programs and services. For example, the operating division intends to improve taxpayer education and assistance through research and analysis of taxpayer characteristics and behavior. However, according to IRS, it does not have enough employees who possess the requisite skills, such as market research, forecasting, and trend analysis. Such limitations could delay the operating division's ability to develop and deliver specialized education and assistance to small businesses.

⁷ Tax Systems Modernization: Management and Technical Weaknesses Must Be Corrected If Modernization Is To Succeed (GAO/AIMD-95-156, July 26, 1995) and Tax Systems Modernization: Blueprint Is a Good Start But Not Yet Sufficiently Complete to Build or Acquire Systems (GAO/AIMD/GGD-98-54, Feb. 24, 1998).

SB/SE and IRS Will Be Challenged to Develop and Implement a Performance Management System

A coherent organization and management structure dedicated to small businesses will not significantly improve service to taxpayers without a performance management system that aligns employee, program, and strategic performance measures and creates incentives for behavior that supports agency goals. IRS has made some headway in this area as it develops a new set of performance measures balancing customer satisfaction, employee satisfaction, and business results and updates its employee evaluation system.

Although IRS has clearly made progress in implementing new performance measures, it is missing a key indicator for voluntary compliance. Such a measure is essential for a number of reasons. Regularly measuring progress in voluntary compliance is important to gauge whether IRS is accomplishing a key aspect of its mission. Also, the information about taxpayers that would be generated in measuring voluntary compliance may help IRS identify the characteristics of taxpayers who have difficulty understanding and meeting their tax responsibilities. Finally, the data IRS would develop as part of any voluntary compliance measurement effort may allow IRS to better direct its enforcement resources to those taxpayers that willfully flaunt the tax laws, thus reducing the burden on compliant taxpayers. The absence of a measure of voluntary compliance could hinder SB/SE more than other operating divisions because, as already mentioned, the SB/SE population generally has a greater potential for noncompliance. IRS recognizes that it needs a reliable and meaningful measure of voluntary compliance and is working with a contractor to determine how to measure compliance with the least burden on taxpayers. However, that effort is still in its early stages.

A second critical aspect of performance management is an employee evaluation system that reflects the organization's mission. As mentioned earlier, SB/SE intends to refocus its compliance capabilities to provide a mix of education and outreach along with an integration of examination and collection—IRS' traditional compliance activities. IRS recognizes that a successful blend of customer service and compliance activities will require not only a substantial shift in employees' skills and abilities but also a significant change in employee attitude and behavior. IRS recognizes that to achieve this shift and a more balanced mix of customer service and traditional compliance activities, employees must have a clearer line of sight between their day-to-day activities, their resulting performance evaluations, and the agency's broader goals. IRS is exploring several different approaches for revising its employee evaluation system to make the relationship between employee performance and agency performance more transparent.

IRS Is Pursuing a Multi-phased Approach in Developing New Burden Estimation Methods

Besides measuring voluntary compliance, as discussed earlier, it is also important that IRS be able to measure compliance burden. To do that, IRS is pursuing a multi-phased strategy. Initially, IRS is focusing on taxpayers who are to be served by the new Wage and Investment Income Operating Division (W&I)—those taxpayers who derive all of their income from wages, pensions, interest, dividends, and capital gains. In subsequent phases, IRS plans to develop estimates for other taxpayer groups, such as small businesses and the self-employed and large and mid-sized businesses.

IRS' incremental approach is intended to mitigate the risks associated with developing a new methodology for estimating compliance burden. The approach should give IRS and its contractors an opportunity to incorporate lessons learned from early phases of the process into later efforts. It also gives IRS the flexibility to significantly modify or terminate the overall development process or its relationship with a particular contractor. IRS' Office of Program Evaluation and Risk Analysis is responsible for overseeing the contractor's work.

The first phase of the development process focuses on the design and implementation of models for estimating the federal income tax compliance burden of W&I taxpayers. This taxpayer group was selected for the initial phase because it accounts for a large share of IRS' overall compliance burden and because its burden may be the easiest to estimate. The conceptual definition of compliance burden developed for this group, along with the theoretical framework for measuring that burden, are supposed to build a foundation for developing burden estimates for other taxpayer groups.

The timing of later phases will depend on resource availability and the accumulation of experience. IRS expects to contract out later this year for a study that would develop a methodology for estimating the time and money that self-employed individuals spend preparing and filing their federal income tax returns. The agency also expects to begin work on employment taxes later this year and on small corporate taxpayer burden in calendar year 2001.

New Estimation Models for W&I Taxpayers Are in Development

IRS has begun to implement its strategy by contracting for the development of two models that, when combined, should provide more reliable estimates of W&I taxpayers' prefilling, filing, and postfiling compliance burdens. Compared with IRS' current methodology, these models are designed to produce more comprehensive estimates of federal income tax compliance burdens and to provide IRS with a greater capacity

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to analyze the impact of tax law and administrative changes on those burdens. As with all such modeling, the specific capabilities and precision of the new models will depend on the quality of the underlying data.

PricewaterhouseCoopers, the contractor engaged to assist IRS in the initial phase of its strategy, began work on the modeling effort in September 1998. The first model, which is to estimate prefiling and filing burdens is expected to be delivered to IRS in May 2001. A second model, which is to estimate postfiling burdens, also is expected to be designed by then, but the operational model is to be delivered at a later date. The cumulative cost of this initial effort is expected to reach approximately \$5 million by the end of fiscal year 2001. Expenditures for later years have not yet been determined.

Mr. Chairman, this concludes my prepared statement. I would be happy to answer any questions you or other Members of the Committee might have.

Contact and Acknowledgements

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